THE PHILIPPINE WATER REVOLVING FUND FOLLOW-ON PROGRAM

# ADVANCING REFORMS IN SUPPORT OF THE PHILIPPINES WATER REVOLVING FUND

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Under the Philippine Water Revolving Fund (PWRF) Support and Follow-on Programs, USAID supported the Philippine Government's efforts to achieve universal access to safe, adequate and sustainable water supply and sanitation for all Filipinos[1]. A program that began with a focus on how to expand available financing for water and sanitation infrastructure projects grew to touch all aspects of water and sanitation services--operation, financing and regulation. As the PWRF Follow-on Program wraps up, we are taking this opportunity to reflect on what has been achieved and to outline some priority reforms that still need attention in order for the Government of the Philippines (GPH) to achieve its vision for universal access to clean water and sanitation services. While many areas in the sector will need continued support and attention in the coming years (i.e. improving water utility operations and water security, and expanding services in rural areas), the execution of financing and regulatory reforms in the near term are likely to have the greatest positive long term impact on the health and well being of Filipinos. This paper outlines several proposed reform areas for USAID consideration that, if pursued and supported by the GPH, would significantly impact the sector within a shorter period.

# 1 Background

USAID significantly re-engaged in the water and sanitation (WSS) sector following the passage of the Paul Simon Water for the Poor Act. While USAID had other investments in the sector (i.e. EcoGov and LINAW focused on local government investments in waste collection and treatment), the PWRF Support and Follow-On Programs served as USAID's principal comprehensive program that addressed a diverse array of sector issues. USAID assistance to GPH was initially borne out of the need to bridge the *funding gap* that stood in the way of achieving the country's MDG targets. Early studies by the World Bank and USAID estimated that the country needed to invest about PhP40 billion per year in water and sanitation infrastructure and upgrades while GPH annual investments totaled about PhP 3-4 billion a year[2]. This difference translated into significant underinvestment in this critical sector. Since neither the government nor donors could make up the shortfall, the remaining alternative was to mobilize private financing which became the catalyst that sparked sector wide reform.

**THE PWRF APPROACH.** The USAID-JICA funded Philippine Water Revolving Fund (PWRF) Support Program began in 2004 with the objective of mobilizing private financing for utilities to increase access to clean water. The PWRF Support Program used the establishment of a water revolving fund to address the immediate objective of *mobilizing private finance* and as a lever of change to help improve the governance and efficiency of the water sector. PWRF worked across the water utility, government regulatory and financing marketplace to enable the market at three key entry points – *Financing, Operational Strengthening, and Regulatory Clarity*. The team worked simultaneously at different marketplace pressure points to align incentives for change

[1] Philippines Water Sector Roadmap and the Draft Philippines Sustainable Sanitation Roadmap

[2] The World Bank Report on Meeting Infrastructure Challenges in the Philippines, 2005 estimated investment requirements of PhP5-6 billion a year for water supply and PhP35 billion a year for sanitation services to comply with the Clean Water Act.

and garner support from a wide array of stakeholders to build momentum for reform. Support included:

- ***Innovative Financing*** – The *Water Revolving Fund mechanism* established a co-financing arrangement that could blend public/donor funds with private loans and provide financing in the terms and tenors required for long-term investments in water and sanitation infrastructure. The innovative PWRF model provided banks with a low-risk entry into a new market, while giving utilities access to new affordable financing streams (lower rates and longer maturities). Alongside the PWRF mechanism, the program developed a *utility credit risk rating system* and built capacity of lenders in *water and sanitation project appraisal* that enabled them to better assess and identify bankable opportunities.

- ***Utility Operational Strengthening*** – Until utilities could operate as viable commercial enterprises and develop bankable projects, commercial banks would be reticent to sustain and deepen their involvement in the sector. The PWRF program drove activities in *utility reform* such as business planning and improved financial management, and deepened its impact by consolidating training under the Philippines Association of Water Districts (PAWD). The Project sponsored and encouraged collaborative *project development* that helped lenders and borrowers communicate on how to create bankable projects, while also exposing utilities to the financial rigor of commercial loans.

- ***Regulatory Clarity*** – Regulatory clarity plays an important role in compelling utility performance and investments, provides incentives for network expansion, removes political interference, and encourages long term planning by water service providers. To create clarity, the program facilitated the drafting of a legislative bill to create a single *Water Regulatory Commission*, an independent quasi-judicial body with the power to take punitive measures on utilities that fail to meet network expansion and quality of performance targets. The Project also supported *public investment rationalization* to provide greater clarity on the allocation of public funds designed to meet the needs of the poorest and most disadvantaged "waterless" municipalities, as well as policy on leveraging public with private funds, an attractive step for commercial banks.

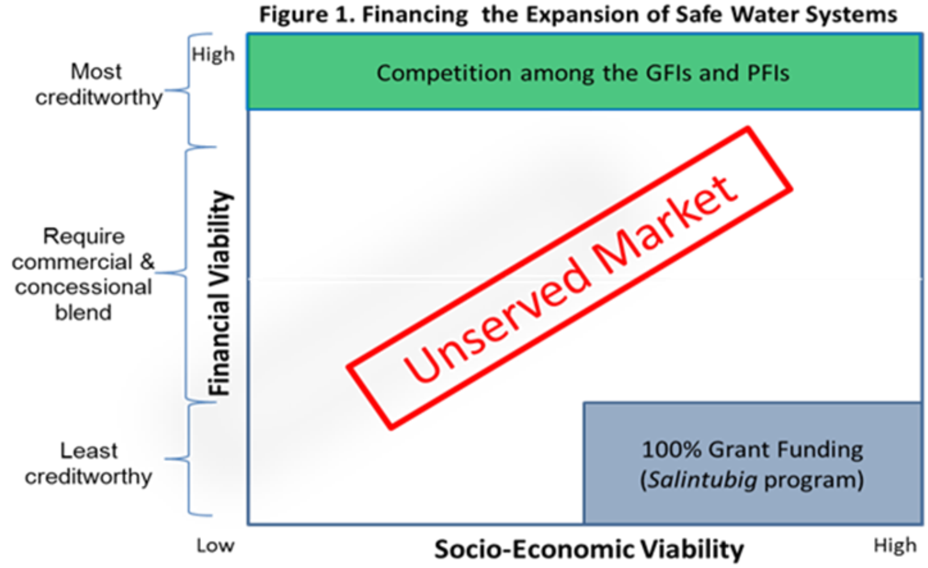
**IMPACT.** While many reforms launched with PWRF support remain in progress, the PWRF Support and Follow-on Programs have achieved impressive gains and driven a paradigm shift where Philippine water utilities are no longer entirely dependent on national government and donor funding to finance water and sanitation infrastructure. To date, more than 3.8 million people are projected to benefit from PWRF or PFI-funded projects; of which about1.3 million people actually have access to clean water from completed projects. The pipeline of projects continues to build. The PWRF has helped mobilize more than PhP 7.1 billion in financing for water and sanitation infrastructure – of which more than 60% is from private banks and developers. In sum, the PWRF has significantly contributed to helping the Philippines advance towards the goal of universal access to safe, clean water and sanitation services for all by 2025. An additional and often overlooked benefit is the role the PWRF Support and Follow-On Programs have played serving as the Technical Secretariat to the multi-stakeholder Sub-Working Group on Water Supply and Sanitation (SWG WSS) of the Philippine Development Forum. This role enabled USAID to take a lead position among the donor community in working with senior GPH officials and stakeholder group representatives to assess and debate sector issues and priorities and help shape the sector reform agenda.

# 2 The Way Forward

In spite of this impressive progress made over the past seven years, many critical reforms remain incomplete. For example, the Department of Finance delayed action on the rationalization of public investments and regulatory reforms being promoted by the SWG WSS since 2010, where they remain stalled today. The GPH has also only recently named a champion for the sector who has yet to review and appreciate sector financing reforms, among others. This lack of action by the GPH risks weakening reform initiatives already underway and ultimately undermining the GPH's ability to achieve its objectives for universal water and sanitation coverage. The following section outlines several reforms that remain critical to the development of the WSS sector.

## 1. Expanding Financing for More WSS Projects.

Figure 1. Financing the Expansion of Safe Water Systems




In spite of the positive growth in private sector investment in the sector, a recently updated financing assessment commissioned by MDG F-1919 (joint program of GPH and UN Partners) estimated that the country still needs to invest between PhP9 - 18 billion annually to meet the universal coverage goals. Meeting this financing need will require mobilizing funds from national government, donor and private sector sources.

While the GPH is proud of its establishment of the PWRF as the first water revolving fund outside Europe and the United States, it can do more to translate the PWRF into a more comprehensive approach for sector financing. The current policy framework essentially creates two financing options for water projects. At one extreme there is the *Salintubig* program that provides direct grants to poor municipalities where more than half the population have no access to clean water. In the past two years, this program has channeled approximately PhP 2.78 billion to help 278 of 455 waterless municipalities improve water supplies. At the other end of the market, you find intense competition between GFIs and PFIs (through the PWRF and direct lending) for the few projects being developed by the credit worthy water service providers. This approach leaves the majority of the approximately 500 water districts and 1,000 LGU-managed water systems with few financing options as depicted in Figure 1.

To expand the number of water and sanitation service providers able to access appropriate and affordable financing will require several deliberate policy decisions by the GPH that will improve and expand the market structure for financing water and sanitation projects. Ideally, such a structure would be able to deliver financing that is tailored to the specific needs of the water and sanitation service provider. The following recommendations would help establish such a market structure and make financing available for more projects.

a. **Reduce bureaucratic red tape for new projects**

   - Rationalize and streamline the process of securing LWUA waivers. Under the legal mandate of LWUA and water districts (Presidential Decree 198), water districts that have outstanding loans to LWUA must get a waiver from LWUA before securing additional loans from other sources. While designed to ensure that water districts do not become over-extended, this requirement has effectively enabled LWUA to block water districts from refinancing existing debts to take advantage of lower interest rates or to sign new loans with GFIs or PFIs to expand systems and improve services. Removing this restriction will free up water districts to seek financing from the most advantageous sources.

   - Streamline the Central Bank/Monetary Board Opinion process. The New Central Bank Act require LGUs and Water Districts to secure a Monetary Board opinion regarding the monetary and balance of payments implications of any loan before they can sign the loan. Securing this opinion requires considerable documentation --including pre-requisite approvals or certifications from Department of Finance and Department of Interior and Local Government-- and time, and can cause significant delays in securing financing and subsequently the completion of projects. Streamlining this process can remove some of the uncertainty and therefore risk for lenders willing to consider loans to LGUs and water districts.

b. **Create a level playing field between GFIs and PFIs.** Currently, we see intense competition between GFIs and PFIs for the same highly creditworthy projects and borrowers. Yet GFIs have a built-in advantage over PFIs as they secure some of their funding from ODA loans at less than commercial market terms and have the exclusive right to serve as depository banks for LGUs and water districts. If the government wants to attract more PFI financing for the sector, it needs to create a level playing field between GFIs and PFIs. The following policies would help address this imbalance:

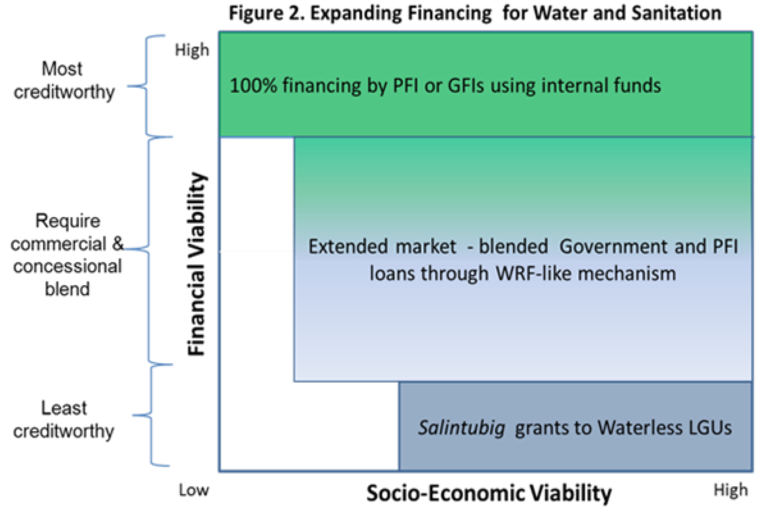
- Allow GFIs to compete directly with PFIs for the most creditworthy projects <u>only when they will fully finance the projects using their internal</u> funds (i.e. those funds raised from domestic sources rather than ODA loans).

- Require that all ODA loans for water and sanitation be leveraged with private financing. JICA created the precedent for this which has subsequently attracted significant private sector funding to the sector. Putting in place this policy would help equalize all ODA loan facilities and encourage greater teamwork with PFIs in financing large projects.

- Allow PFIs to become depository banks for LGUs and water districts – at least for funds held in escrow on loans PFIs have made to these institutions. Making this change in current regulations will strengthen the guarantees that PFIs have against default and deepen their financial relationships with LGUs and water districts.

c. **Align GPH grants with a mechanism that tailor financing to the needs of specific projects.** As noted above, we currently see intense competition for commercially viable projects between GFIs and PFIs and the use of the GPH grants for "waterless" LGUs. Addressing the gap in the middle represents both the greatest need and largest potential market. However, as recognized in EO 279, meeting this market gap requires the ability to provide funding that is tailored to the financial needs and ability to repay of each project. For example, many water districts have elected to not extend their systems into remote or very poor areas because of fears that these projects will adversely impact their balance sheet. One way to overcome this obstacle is to use the PWRF or a PWRF-like mechanism that can blend public grants and commercial financing (from GFIs and/or PFIs) in order to tailor financing to the specific requirements of each project. Such a facility could for

**Figure 2. Expanding Financing for Water and Sanitation**



example, create more affordable financing for projects, like those of *Salintubig* graduating LGUs that have high socio-economic viability but are not financially viable at pure commercial rates.

By undertaking the above recommendations, the GPH can stimulate greater PFI investment in the sector, greatly expand the number of projects being funded, and address the large number of projects that the current market of GFI/PFI and Salintubig grants do not fund as shown in Figure 2.

In addition to the above recommendations, two other areas are showing great promise and merit USAID attention.

d. **Promote public-private partnerships (PPPs) to address specific service challenges**. Assist water districts and LGUs to package PPP projects for bulk water supply, septage management and non-revenue water performance-based contracts (NRW PBC). These PPP arrangements can remove the upfront financing burden on the water/sanitation service provider, and introduce new and more efficient management and operating approaches. While there is great interest among some companies, the banks will likely insist on a guarantee of payments or expected income streams as a result of the PPP project before funding such projects. Making the USAID DCA guarantee available to these projects will require a modification in the current agreement between USAID and the LGUGC.

## 2. Improve Regulatory Clarity and Strengthen Enforcement

Regulation remains a critical element for achieving universal coverage and improving water and sanitation service performance. Since USAID is one of the few donors that have focused on the importance of regulation, the following recommendations are for USAID consideration:

a. **Provide institutional support to NWRMO**. There exists considerable interest within the GPH in establishing a National Water Resources Management Office. This office will serve as the counterpart to the proposed Water Regulatory Commission and focus on water resource regulation. This office will play an important role addressing the growing number of issues around water rights and use, and improve how water resources are managed. If the GPH establishes this NWRMO, USAID should consider providing technical assistance to support its organization, installation of systems and building capacity of its staff.

b. **Continue supporting efforts to reform economic regulation of the sector**. The WRC is an essential institution to improve how water utilities operate and potentially force the merger of small and/or poor performing utilities with larger and better operated ones in order to improve sector performance overall. The WRC bill can be re-filed in the 16$^{th}$ Congress and USAID can continue to play a critical role by providing technical support to NEDA, the NWRB and the SWG WSS to raise awareness in Congress and the Office of the President about the proposed economic regulatory reforms, and to monitor and shepherd the WRC bill in the legislative process.

c. **Follow up support for the adoption of a pricing policy for septage management services** – The PWRF Follow-on Program worked with LWUA to develop a draft pricing policy framework for septage services. This now needs to be expanded to include operating guidelines for septage pricing. Given the importance of improving waste collection and treatment, and USAID's past leadership in this area, we recommend it provide LWUA with additional support to develop such pricing guidelines complemented with a manual for rate setting and adjustment. In addition, LWUA may need assistance in setting the standards of service that should be factored in the economic regulation of septage management services.

While the needs of the WSS sector remain considerable, much progress has been made over the past seven years in large part due to USAID's assistance. We have highlighted the above priorities as those that offer the potential for significant and far reaching impacts within the next three to five years.